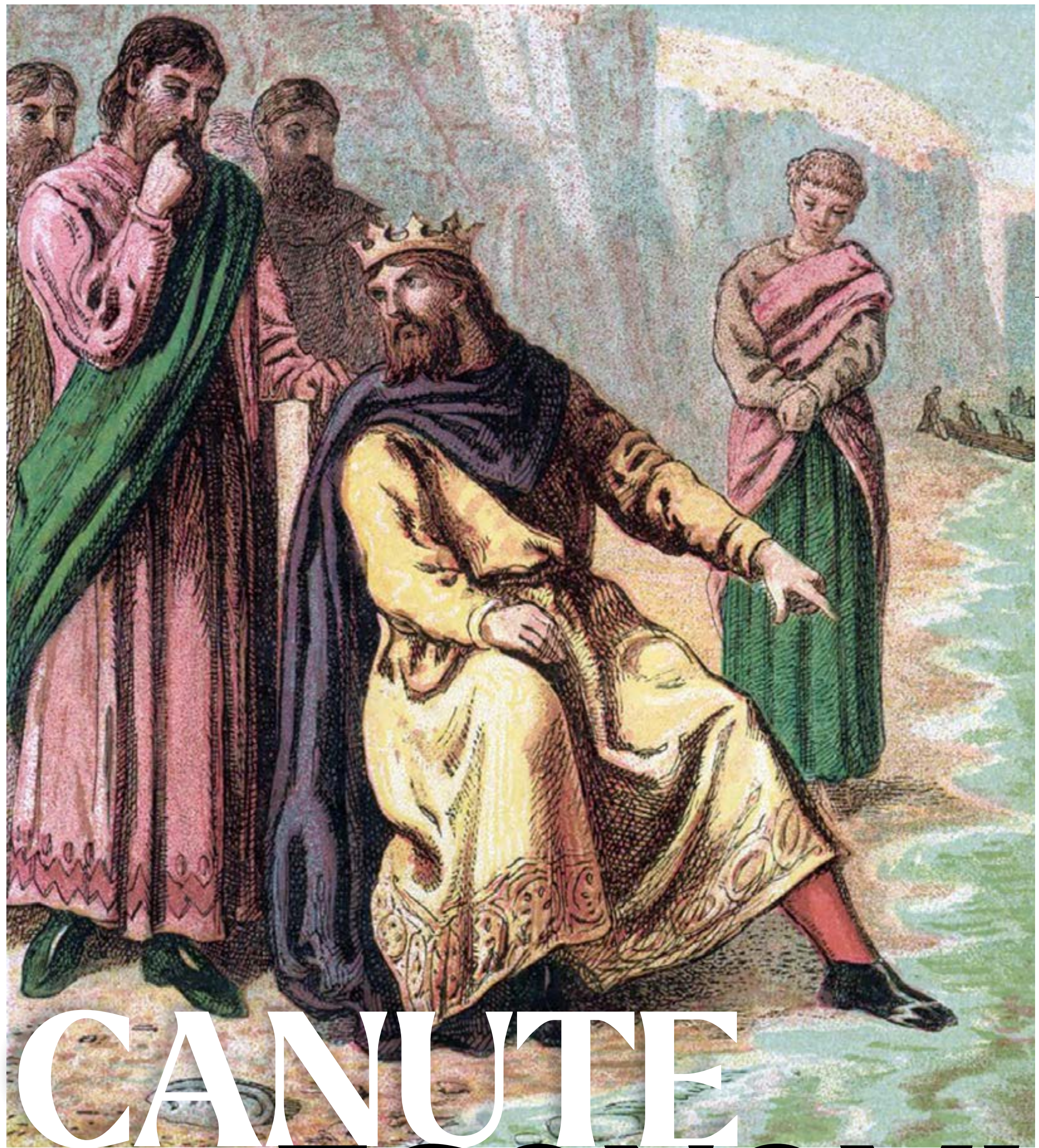

King Canute, ruler of the North Sea Empire, illustrated by German lithographer Joseph Martin Kronheim.

CANUTE ECONOMICS

Economist Geoff Bertram on why the turning tides of price increases doesn't mean government can claim credit for cutting inflation.

There is a famous story about King Canute, who set his throne by the sea shore and commanded the tide to halt and not to wet his feet and robes. Yet continuing to rise as usual, the tide dashed over his feet and legs. Then the king leapt backwards, saying "Let all men know how empty and worthless is the power of kings".

Watching the Reserve Bank and the Minister of Finance celebrate their claimed "victory over inflation" I found myself reflecting that Canute could have changed the story by parking his throne at the high tide mark rather than further down the beach, and boldly claiming credit for turning the tide.

Illustration: Wikimedia Commons.

It's true that inflation has slowed down. But it's not obviously true that either the Reserve Bank or the Government can claim any credit. One really telling bit of information in the latest inflation figures is that prices for tradable goods have fallen in the past year, while prices for non-tradables are still tracking stubbornly high at 5 per cent inflation. The 2.2 per cent overall inflation rate that dominates the headlines is just the average of those two figures.

This distinction matters because the prices of tradable goods are set overseas (that's the point of their being tradable) and it's the fall in global inflation that has driven those prices down, not anything the Government or Reserve Bank has done.

The prices that these entities can potentially influence are the ones that are set within New Zealand, the non-tradables — such as electricity, bank fees, insurance premiums, rent, rates, and road user charges — where the inflation rate is still 5 per cent, with more electricity price hikes on the horizon and both central and local governments increasing charges for a range of services.

There's more than a whiff of what President George H.W. Bush memorably called 'voodoo economics' — making policy by slogan rather than by analysis — in the official story, which tends to be uncritically repeated in the mainstream media. In that story inflation can be cured by raising interest rates, which drives the economy into recession, which puts downward pressure on wages and prices, and so inflation stops. Job done.

One part of that story definitely works: the how-to-cause-recession bit. There's no doubt that the Reserve Bank can crash the economy by pushing interest rates up. Equally it's clear that the Government can crash the economy by cancelling contracts, firing public servants, and slashing expenditure on infrastructure. But whether either of those socially destructive policies makes a dent in inflation depends on a thing called the Phillips Curve, and its companion in the economics literature, the "sacrifice ratio".

The Phillips Curve is the proposition that inflation goes up in booms and falls in the slumps. It is named after a great New Zealand economist, Bill Phillips, who published his famous paper "The Relation Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861–1957" in 1958. The theory suggests that tight labour markets drive up wages due to increased worker bargaining power, while high unemployment leads to wage stagnation or decline. Consequently, price inflation would move in lockstep with wage increases.

That story was half-credible in New Zealand for a long time before Rogernomics took hold in the 1980s. Workers did have genuine bargaining power, exercised both through the union movement and through the procedures for setting wage awards, and full-employment times of labour scarcity did strengthen the ability of organised labour to demand increases. The economists' shorthand way of putting this is to say that the "wage Phillips Curve" sloped up.

The story was only half-credible as an explanation for inflation because there were a lot of other things that in reality affected the inflation rate quite apart from wage increases. Local firms increasing their markups and price-gouging consumers, for example. Governments printing too much money. Oil producers forming a cartel and forcing up the world price of oil, as happened twice in the 1970s.

For politicians — especially right-wing ones — however, the convenient narrative was to blame workers and to target wages as the way to beat inflation, whatever the actual cause.

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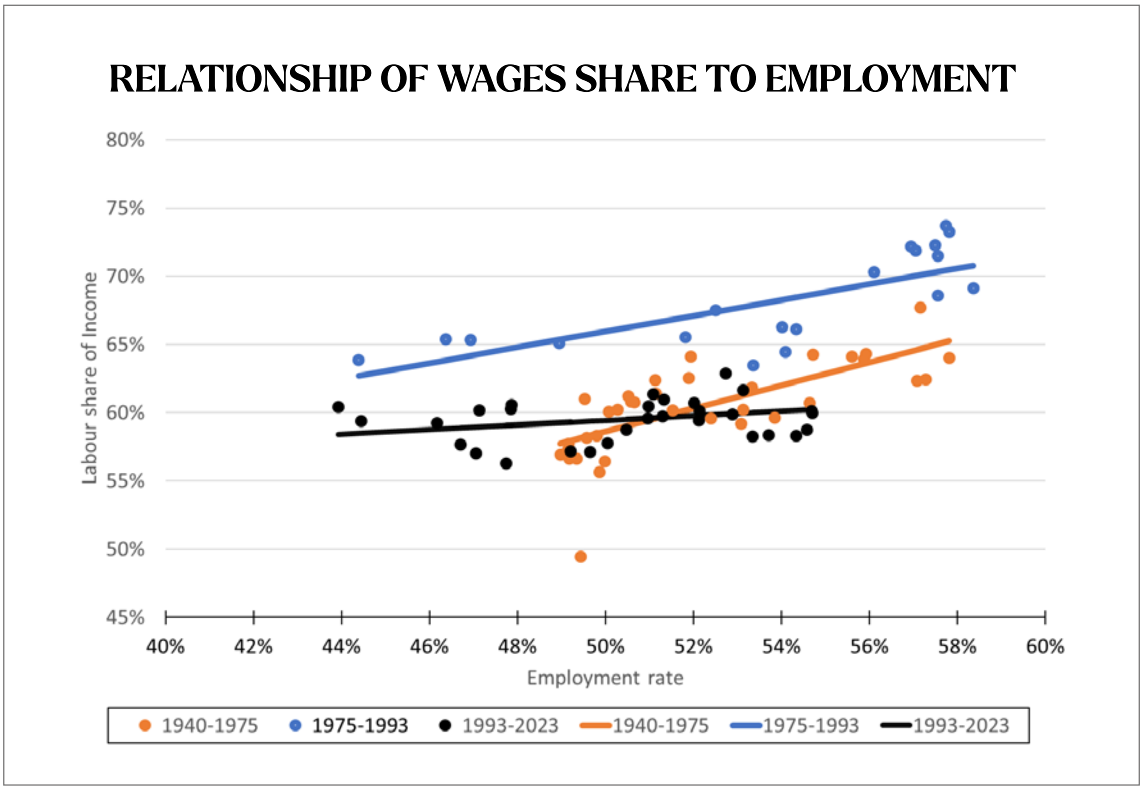
Following the rise of Reagan and Thatcher, though, labour suffered an historic defeat in its struggle with capital across much of the developed world. The wages share of national income fell, unions lost traction, and — most important in the inflation story — the wage Phillips Curve was flattened along with the labour movement.

In a recent paper I co-authored with fellow economist Bill Rosenberg, we analysed the bargaining power of workers in New Zealand since 1939, which showed how the wage Phillips Curve has been flattened here and identified



the neoliberal Employment Contracts Act 1991 as the key culprit. Running the risk of boring readers with fancy diagrams and economists' jargon, I have reproduced above one of our charts showing the relationship between the wages share of total income up the vertical axis and the level of employment (reflecting booms and slumps) along the horizontal. The relationship of the wages share to employment is plotted for 84 years, from 1940 to 2023, and the analysis identifies three distinct periods. For two of those, from 1940 up to the early 1990s when the Employment Contracts Act (ERA) was passed, we find upward-sloping lines, which (we say) reflect labour's bargaining power to gain larger wage increases when employment was high. For the third period, 1994-2023, the relationship goes flat: the bargaining power of labour was killed by the ERA, and has never recovered.

Adding to this discourse, the International Monetary Fund's latest *World Economic Outlook* confirms (on page 46 of Chapter 2) that across the world economy, the wage Phillips Curve is pretty well flat these days, so that the inflation of recent years has had nothing to do with wages: "The empirical wage Phillips curve ... did not steepen much in either advanced economies or emerging markets, but shifted upward as short-term inflation expectations increased ... Recent inflation dynamics likely did not reflect ... tightness in the labor market."

On the same page the IMF published a chart showing that for advanced economies other than the USA, booms and slumps in their domestic markets (called "slack" in the chart) have had only trivial effects on inflation, either up or down. The big drivers of inflation have been "energy", "energy pass-through", "other pass-through" and "other" — in other words, the pricing behaviour of firms, not workers.

What those other inflation-drivers do is to push the Phillips Curve itself up and down — in other words, to determine the inflation rate regardless of whether the local economy is in boom or slump. Only the USA stands out as an economy in which inflation responds much to "slack". The rest of the developed economies (including New Zealand) just import the results of the US Federal Reserve's policies.

All this suggests three propositions about the recent inflation in New Zealand. First, as our research described above shows, it wasn't caused by workers or wages and it won't be cured by making life harder for either regular wage workers or so-called "contractors". That won't stop the current Government pretending otherwise.

Second, the tradables part of inflation was imported and so was the slowdown. That won't stop the current Government claiming the credit.

Third, the non-tradables part of inflation (what the IMF calls "pass-through" and "other") requires policies that break the market power exercised by local firms — and causing a recession is not the best way to do that. Supermarket margins, bank fees and margins, electricity prices, insurance premiums, local body rates, central Government charges, construction costs, restaurant prices and all the other non-tradable parts of the cost of living remain pretty impervious to the deepening recession, as ordinary household incomes and budgets go increasingly into the red. New Zealand's central pricing problem is the degree of monopoly in its non-tradeable sectors and the absence of any credible regulatory check on that monopoly power. ■

Graph: Geoff Bertram.